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No. 06-1265

IN THE
Supreme Court of the United States

KLEIN & CO. FUTURES INC.,

Petitioner,

v.

BOARD OF TRADE OF THE CITY OF NEW YORK, INC., *ET AL.*,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF OF *AMICUS CURIAE* FUTURES INDUSTRY ASSOCIATION, INC. IN SUPPORT OF PETITIONER

BARBARA WIERZYNSKI
FUTURES INDUSTRY
ASSOCIATION, INC.
2201 Pennsylvania Ave., NW
Washington, DC 20006
(202) 466-5460

MARK D. YOUNG
CHRISTOPHER LANDAU, P.C.
Counsel of Record
GREGORY L. SKIDMORE
KIRKLAND & ELLIS LLP
655 Fifteenth St., NW
Washington, DC 20005
(202) 879-5000

July 19, 2007

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Pursuant to this Court's Rule 37.2, *amicus curiae* respectfully files this brief in support of petitioner.*

STATEMENT OF INTEREST OF *AMICUS CURIAE*

The futures industry is a major engine of the American economy: every day, more than *$5 trillion* worth of futures contracts and related options are traded on futures exchanges in this country. The Futures Industry Association (FIA) is a national trade association for that industry. Its regular membership consists of 35 of the Nation's largest futures brokerage firms, and its associate membership consists of approximately 150 firms involved in virtually all other segments of the industry. FIA regular members execute customer orders for, and provide the financial guarantees underwriting, more than 90% of all transactions on the United States futures markets. Petitioner Klein is not, and never has been, an FIA member; respondents New York Clearing Corporation and Board of Trade of the City of New York are associate members. Neither regular nor associate members are bound by the views taken by FIA as *amicus*.

FIA has a strong interest in any case that affects the futures industry, and has participated as *amicus curiae* in several such cases, including *eBay, Inc. v. MercExchange, LLC*, 126 S. Ct. 1837 (2006), *Dunn v. CFTC*, 519 U.S. 465 (1997), and *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353 (1982). FIA has a particularly strong interest in cases involving the interpretation of the Commodity Exchange Act (CEA), the federal statute that establishes the regulatory framework governing the

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* Pursuant to this Court's Rule 37.6, *amicus* states that no counsel for a party authored this brief in whole or in part, and no person or entity other than *amicus* has made a monetary contribution to the preparation or submission of this brief. All parties have consented to the filing of this brief *amicus curiae*, and their consent letters are on file with the Clerk's Office.

futures industry and the relevant regulatory agency, the Commodity Futures Trading Commission (CFTC).

This case presents such an issue. As explained below, the Second Circuit misinterpreted the CEA's plain language to deprive clearing firms like petitioner of their statutory cause of action against statutory "registered entities" like respondents. That error affects the interests not only of the parties to this case, but of the entire futures industry, by exposing clearing firms to substantial financial harm resulting from bad faith misconduct by registered entities without any remedy against those entities. Because that decision threatens to destabilize those firms whose capital provides the financial backbone for this important industry, FIA hereby files this brief supporting petitioner.

BACKGROUND

Because the decision below displays a fundamental misunderstanding of the operation of futures markets, some background may be helpful.

Futures and related options contracts are traded on futures exchanges. Individual customers who wish to buy or sell futures contracts may not do so directly; rather, they must carry out their transactions through brokerage firms called futures commission merchants. Such merchants arrange for the execution of customer orders either through floor brokers in a trading pit or on a computerized trading screen, as specified in the rules of the relevant exchange.

When the terms of an offer to sell are accepted by the buyer (or vice versa) in the pit or on the screen, a trade occurs. Under exchange rules, however, a given trade cannot be finalized until it is "cleared" to remove the risk that the underlying buyer or seller will not perform their mutual obligations. This clearing process is integral to the efficient operation of the Nation's futures markets.

The clearing process is carried out through an exchange's "clearing house." Under exchange rules, those futures commission merchants that are members of the clearing house, also called "clearing firms," submit the trade to the clearing house. The clearing house confirms the details of the trade, and then substitutes itself as the seller to the buyer's clearing firm and the buyer to the seller's clearing firm. In this manner, the clearing house removes the underlying buyer's risk to the underlying seller and the underlying seller's risk to the underlying buyer. The clearing house has no contact with (and may not even know the identity of) the underlying buyer or seller; rather, the clearing house deals only with the clearing firms on a principal to principal basis.

To protect itself from risk, a clearing house requires clearing firms to guarantee their ability to pay the aggregate losses on the contracts they carry on behalf of their customers. The clearing firms provide this guarantee through accounts they maintain at the clearing houses. At the end of each trading day, the relevant exchange determines (either through a committee or other means) the "settlement price" for each commodity futures contract and related option traded on that exchange. The clearing house then applies the settlement price to the open customer positions in the clearing firms' accounts, and adjusts those accounts accordingly. Losses are debited from the clearing firm's account, and gains are credited to the clearing firm's account. Through this daily adjustment process, the clearing firms make good on their obligations to the clearing house *regardless* of whether the underlying buyers and sellers make good on their obligations to the clearing firm. The clearing firm, in other words, is financially responsible to the clearing house for all the trades that it clears.

This case involves trades by one Norman Eisler, who was then Chairman of respondent New York Futures Exchange (a wholly owned subsidiary of respondent New York Cotton Exchange, which in turn is a wholly owned

subsidiary of respondent Board of Trade of the City of New York). In that capacity, Eisler was a member of the settlement committee for Pacific Stock Exchange Technology Index Futures (P-Tech futures and options), which set the daily settlement price for such trading instruments. Eisler carried out his own trading through a company called First West Trading.

As relevant here, First West hired petitioner Klein, a clearing firm, to submit the trades for clearing to the clearing house for the New York Futures Exchange, respondent New York Clearing Corporation. The problem here arose because (according to the allegations in petitioner's complaint, which must be taken as true at this stage of the proceedings) Eisler abused his position as Chairman of the New York Futures Exchange and a member of the P-Tech settlement price committee in an attempt to enrich himself. Pet. App. 3a. In particular, he manipulated the settlement price of P-Tech options for nine months in 1999-2000 to ensure that his company's contracts appeared profitable and thereby avoid any margin calls from Klein. Pet. App. 3a-4a. When the New York Futures Exchange and the New York Clearing Corporation finally discovered and attempted to rectify this misconduct, the settlement price for P-Tech options was corrected almost overnight, causing a radical decline in the value of P-Tech options and substantial margin calls. Pet. App. 5a. First West then defaulted on its obligations to Klein, and Klein in turn defaulted on its own independent obligations to the New York Clearing Corporation. *See id.* Accordingly, Klein was forced out of business and brought this lawsuit.

SUMMARY OF ARGUMENT

Section 22 of the CEA, codified at 7 U.S.C. § 25, creates two different causes of action. The first, set forth in Section 22(a), creates a cause of action against entities other than statutory "registered entities." The second, set forth in Section 22(b), creates a cause of action against

statutory "registered entities." Respondents here are statutory "registered entities." Accordingly, this case is governed by Section 22(b), not Section 22(a).

The Second Circuit, however, held that petitioner's claims against respondents failed as a matter of law because they failed to meet the requirements of Section 22(a). That holding is plainly erroneous for the simple reason that this is a Section 22(b) case, not a Section 22(a) case. The Second Circuit gave no explanation for applying the requirements of Section 22(a) to a claim under Section 22(b), and there is no reason in law or logic to do so. Because petitioner has stated a claim under Section 22(b), the judgment should be reversed.

Over and above its misreading of the statute, the Second Circuit displayed a fundamental misunderstanding of the operation of futures markets. In particular, the court appears to have assumed that futures clearing firms are not themselves on the hook for losses stemming from transactions cleared for their customers. That assumption is incorrect. Futures clearing firms are independently liable to futures clearing houses for losses arising from transactions undertaken on their customers' behalf. Thus, it makes sense for Congress to have given futures clearing firms like petitioner a cause of action against "registered entities" like respondents where (as alleged here) respondents' violations of their own rules caused petitioner's losses.

ARGUMENT

The Second Circuit Erred, And Destabilized The Nation's Futures Industry, By Stripping Clearing Firms Of Their Statutory Cause Of Action Against Registered Entities.

As a threshold matter, there can be no real dispute that the Second Circuit erred by construing the CEA to deprive clearing firms like petitioner of a cause of action against registered entities like respondents. Such a cause

of action is expressly conferred by Section 22 of the CEA, codified at 7 U.S.C. § 25, which authorizes claims against "[a] registered entity that fails to enforce any bylaw, rule, regulation, or resolution that it is required to enforce" by "a person who engaged in any transaction on or subject to the rules of such registered entity to the extent of such person's actual losses that resulted from such transaction and were caused by such failure to enforce or enforcement of such bylaws, rules, regulations, or resolutions." *Id.* § 25(b)(1).

That is the beginning and the end of this case. There is no question that respondents are "registered entit[ies]." *See id.* § 1a(29) (defining "registered entity" to include "a board of trade designated as a contract market," "a derivatives transaction execution facility," and "a derivatives clearing organization"). Petitioner alleges that it is "a person who engaged in any transaction on or subject to the rules of such registered entit[ies]," *id.* § 25(b)(1), including most obviously clearing those trades subject to respondents' rules. Petitioner alleges that respondents "fail[ed] to enforce any bylaw, rule, regulation, or resolution that [they are] required to enforce" by permitting Eisler to fraudulently manipulate the P-Tech options settlement price, and that as a result petitioner suffered "actual losses ... caused by such failure to enforce or enforcement of such bylaws, rules, regulations, or resolutions." *Id.*

The Second Circuit did not deny any of these straightforward points. Rather, the Second Circuit began its analysis by correctly noting that "Section 22 includes two types of claims": "Section 22(a) relates to claims against persons *other* than registered entities and registered futures associations," whereas "Section 22(b) deals with claims against [registered] entities and their officers, directors, governors, committee members and employees." Pet. App. 7a (emphasis added; citing 7 U.S.C. §§ 25(a), (b)). This case, as the Second Circuit recognized, involves a Section 22(b) claim: petitioner is

suing registered entities. *See* Pet. App. 8-9a; 11a. Such a claim, as the Second Circuit again recognized, is "available only to a private litigant 'who engaged in ... transaction[s] on or subject to the rules of a contract market.'" Pet. App. 8a (quoting 7 U.S.C. § 25(b)(1)-(3)).

The Second Circuit, however, never analyzed the critical issue whether petitioner is "a person who engaged in any transaction on or subject to the rules of" a contract market or other registered entity, 7 U.S.C. § 25(b)(1), within the meaning of Section 22(b). Instead, the Second Circuit simply assumed without analysis that a person pursuing a claim under Section *22(b)* is subject to the limitations applicable to a person pursuing a claim under Section *22(a)*. *See* Pet. App. 7-8a ("The text of the two subdivisions requires that a putative plaintiff fall within one of the four required relationships set forth in § 22(a)(1)(A-D)."); Pet. App. 9a ("[Petitioner] does not fall within any of the required subdivisions of § 22(a)(1)(A)-(D).").

That is a complete non sequitur. Sections 22(a) and (b) create different causes of action by different plaintiffs against different defendants. Section 22(a) creates a cause of action against non-registered entities (*i.e.*, intermediaries like traders and brokers), *see* 7 U.S.C. § 25(a), whereas Section 22(b) creates a cause of action against registered entities, including designated contract markets and clearing organizations, *see id.* § 25(b). The requirements of the cause of action under Section 22(a) are set forth in Section 22(a), while the requirements for the cause of action under Section 22(b) are set forth in Section 22(b). Nothing in the statute remotely purports to import the requirements for a Section 22(a) claim into Section 22(b), and there is no basis in law or logic for doing so. *See, e.g.*, *Russello v. United States*, 464 U.S. 16, 23 (1983) ("[W]here Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the

disparate inclusion or exclusion.") (internal citation omitted); *see also Omni Capital Int'l, Ltd. v. Rudolf Wolff & Co., Ltd.*, 484 U.S. 97, 106 (1987) (applying this principle to the CEA). The wholesale importation of Section 22(a) requirements into Section 22(b) is especially problematic because specific provisions of Section 22(b) expressly incorporate the provisions of Section 22(a), underscoring that Congress knew perfectly well how to accomplish such incorporation where it wished to do so. *See* 7 U.S.C. § 25(b)(2) (referring to "a person that engaged in any transaction specified in subsection (a) of this section"); *id.* § 25(b)(3) (same).

The Second Circuit did not dispute any of the foregoing canons of interpretation, or otherwise seek to justify its importation of Section 22(a)'s requirements into Section 22(b). Rather, the court appears to have taken that fateful step wholly by inadvertence. As respondents acknowledge, the court appears to have conflated the various defendants involved in this case (which originally included both non-registered entities liable under Section 22(a) in addition to registered entities liable under Section 22(b)). *See* Pet. Opp. 19 ("The text of the court of appeals' holding did not distinguish with any precision between Eisler, First West, the individual defendants, the exchange and the NYCC."). But the statute carefully creates different causes of action against different categories of defendants, so it is imperative for a court to "distinguish with ... precision" whether a given claim is brought under Section 22(a) or 22(b). If the Second Circuit had a reason for importing Section 22(a)'s requirements into Section 22(b), the court at a minimum should have disclosed that reason.

Respondents attempt to confuse matters by arguing that certain amendments to the CEA enacted in the year 2000, after the events at issue here, "recast the category of persons with standing to bring an action under Section 22(b)." Pet. Opp. 21. But, as the relevant legislative history makes clear, those amendments were merely

"technical and conforming." S. Rep. No. 106-390, at 13 (2000); H.R. Rep. No. 106-711, pt. 3, at 21-25, 60 (2000); H.R. Rep. 106-711, pt. 2, at 27-32, 72 (2000); H.R. Rep. 106-711, pt. 1, at 22-26, 41 (2000). In particular, Congress streamlined the statutory language by replacing the terms "contract market," "clearing organization of a contract market," and "licensed board of trade" with the term "registered entity," and then defining the latter term to incorporate the former terms. *See* Commodity Futures Modernization Act of 2000, Pub. L. 106-554, § 123 (2000); *see also* 7 U.S.C. § 1a(29) (defining "registered entity" to include "a board of trade designated as a contract market" and "a derivatives clearing organization").

The 2000 amendments thus brought about no substantive change in Section 22(b). Before 2000, a "contract market" or "clearing organization of a contract market" that failed to perform its enforcement duties could be sued by a person injured by "any transaction on or subject to the rules of such contract market," which included the rules of a "clearing organization of a contract market." 7 U.S.C. § 25(b)(1) (1999). Indeed, under the relevant CFTC regulations, a "contract market" specifically included the market's "clearing house." 17 C.F.R. § 1.41(a)(3) (1976); *see also Board of Trade Clearing Corp. v. United States*, No. 76-1905, 1978 U.S. Dist. LEXIS 20220 (D.D.C. Jan. 11, 1978) (upholding this regulation). And after 2000, a "registered entity" (which includes both "a board of trade designated as a contract market" and "a derivatives clearing organization") that fails to perform its enforcement duties can be sued by a person injured by a transaction "on or subject to the rules of such registered entity," 7 U.S.C. § 25(b)(1). To the extent that respondents suggest that the 2000 amendments affect the resolution of this case, in short, that suggestion is a red herring.

Respondents also attempt to confuse matters by insisting that clearing firms act as "agents" for the underlying buyers or sellers, who remain on the hook for

any losses caused by a transaction. *See* Pet. Opp. 5-17. That argument misses the point. While it is certainly true that clearing firms act on behalf of their underlying customers, and those underlying customers are required to cover any losses through margin payments to their clearing firms, the fact remains that the clearing firms are themselves *independently* liable to the clearing house. A clearing firm must cover any losses from the contracts it clears regardless of the underlying customer's ability to cover such losses. In other words, the underlying customer's failure to pay the clearing firm does not relieve the clearing firm of its *own* obligation to pay the clearing house for any loss incurred on behalf of that customer. This is why clearing firms like petitioner may incur "actual losses" resulting from "any transaction on or subject to the rules" of a registered entity. 7 U.S.C. § 25(b)(1). In this manner, clearing firms assume risks that securities brokers generally do not. *Cf.* H.R. Rep. No. 93-975, at 71 (1974) ("Often erroneously viewed as twins, there is little correlation in theory or in fact between the regulation of futures trading and the regulation of securities transactions.").

The Second Circuit thus displayed a fundamental misunderstanding of the futures industry by declaring that clearing firms have "no financial interest" in their transactions, and do not "face[] essentially the same risks as a purchaser or seller of commodities contracts." Pet. App. 12a. To the contrary, as this Court has recognized, such firms are "essential participants" in futures markets precisely because they are required to guarantee financially their customers' performance by honoring their own clearing obligations even if their customers default. *Curran*, 456 U.S. at 359-60; *see also Leist v. Simplot*, 638 F.2d 283, 287 (2d Cir. 1980) (Friendly, J.) (describing clearing firms as "principals in trading transactions"). Respondents cannot avoid that point by insisting that clearing firms like petitioner do not suffer "*trading* losses" (whatever that means). Pet. Opp. 5

(emphasis added). The statute is not limited to "trading losses"; rather it creates a cause of action for "actual losses" resulting from "any transaction on or subject to the rules" of a registered entity," which petitioner clearly has alleged.

Because a clearing firm guarantees its customers' performance, it makes perfect sense for Congress to have given such firms (as well as their customers) a cause of action against registered entities that cause them actual losses as a result of bad-faith misconduct. Indeed, this case underscores why it would make no sense to limit the cause of action to the underlying customers, since the underlying customer here (Eisler) is the very person who allegedly abused his exchange office to manipulate settlement prices and then defaulted on his obligations. *See* Pet. 9-11. Precisely because petitioner was required to honor its clearing obligations undertaken on Eisler's behalf, it suffered massive losses (and indeed was forced out of business) after Eisler defaulted. Given the financial liability of clearing firms in futures transactions, the Nation's futures markets would be seriously undermined if such firms could be left holding the bag as the result of bad faith misconduct committed by officials of registered entities.

The decision below, in flat disregard of Section 22(b), shifted the financial risk of misconduct away from the registered entities charged with enforcing the rules onto the clearing firms that are engaged in every futures transaction, thereby creating a disincentive for these firms to underwrite the very speculation and risk-taking upon which the futures markets depend. *See, e.g.*, *Curran*, 456 U.S. at 359-60 (noting that clearing firms "have an interest in maximizing the activity on the exchange"). If clearing firms are left without any meaningful recourse for losses caused by bad faith misconduct by registered entities, they will be less willing to risk their capital to finance needed trading activity. Since clearing firms are engaged in every transaction in

the futures markets, this reluctance could decrease the overall liquidity and depth of those markets, and result in greater fluctuations in the prices of basic commodities contrary to the national interest. *See, e.g., id.* at 358.

In sum, the decision below is both indefensible as a matter of law and disastrous as a matter of policy.

CONCLUSION

For the foregoing reasons, this Court should reverse the judgment.

Respectfully submitted,

BARBARA WIERZYNSKI
FUTURES INDUSTRY
ASSOCIATION, INC.
2201 Pennsylvania Ave. NW
Washington, DC 20006
(202) 466-5460

MARK D. YOUNG
CHRISTOPHER LANDAU, P.C.
Counsel of Record
GREGORY L. SKIDMORE
KIRKLAND & ELLIS LLP
655 Fifteenth St., NW
Washington, DC 20005
(202) 879-5000

Counsel for Amicus Curiae

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